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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9868]

RIN 1545-BO93

Electing Small Business Trusts with Nonresident Aliens as Potential Current Beneficiaries

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the statutory expansion of the class of permissible potential current beneficiaries (PCBs) of an electing small business trust (ESBT) to include nonresident aliens (NRAs). In particular, the final regulations ensure that the income of an S corporation will continue to be subject to U.S. Federal income tax when an NRA is a deemed owner of a grantor trust that elects to be an ESBT.

DATES: Effective Date: The final regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Date: The final regulations are applicable to all ESBTs after December 31, 2017.

FOR FURTHER INFORMATION CONTACT: Cynthia Morton, (202) 317-5279.

SUPPLEMENTARY INFORMATION:

Background

This document contains final amendments to the Income Tax Regulations (26

CFR part 1) under sections 641 and 1361 of the Internal Revenue Code (Code).

Section 13541(a) of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2154 (TCJA) amended section 1361(c)(2)(B)(v) of the Code to allow NRAs to be PCBs of ESBTs. As amended, section 1361(c)(2)(B)(v) provides that NRA PCBs will not be taken into account for purposes of the S corporation shareholder-eligibility requirement that otherwise prohibits NRA shareholders. See section 1361(b)(1)(C).

On April 19, 2019, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG-117062-18) in the **Federal Register** (84 FR 16415) proposing regulations under sections 641 and 1361 (proposed regulations). No comments addressing the proposed regulations were received in response to the notice of proposed rulemaking. As no request for a public hearing was received, no hearing was held.

Explanation of Provisions

This document adopts the proposed regulations with no change as final regulations. Where an NRA is a deemed owner of a grantor trust that has elected to be an ESBT, the final regulations ensure that such ESBT's S corporation income will continue to be subject to U.S. Federal income tax. Specifically, the final regulations modify the allocation rules under §1.641(c)-1 to require that the S corporation income of the ESBT be included in the S portion of the ESBT if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules. Accordingly, such income will be taxed to the domestic ESBT by providing that, if the deemed owner is an NRA, the grantor portion of net income must be reallocated from the grantor portion of the ESBT to the ESBT's S portion.

The final regulations also implement Congress' amendment to section 1361(c)(2)(B)(v) by making conforming revisions to §1.1361-1(m). For example, the final regulations update the description of PCBs in §1.1361-1(m)(4)(i) to reflect the ability of NRAs to be PCBs of ESBTs. The final regulations similarly update other provisions in §1.1361-1(m) to reflect that ability.

Effective/Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the **Federal Register**, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**. However, section 7805(b)(2) provides that regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which they relate are not prohibited from applying to taxable periods prior to those described in section 7805(b)(1). Furthermore, section 7805(b)(3) provides that the Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.

Accordingly, to prevent abuse of sections 641 and 1361, and the final regulations thereunder, the final regulations apply to all ESBTs after December 31, 2017.

Special Analyses

The final regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

The final regulations do not impose a collection of information on any entities, including small entities. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the final regulations would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the final regulations would primarily affect sophisticated ownership structures involving ESBTs that have NRAs as PCBs.

Pursuant to section 7805(f), the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Drafting Information

The principal author of the final regulations is Cynthia Morton of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.641(c)-1 is amended by:

1. Revising paragraphs (b)(1) and (2).

2. In paragraph (k):
 - i. Revising the paragraph heading.
 - ii. Removing the language “(l) *Example 1*” and adding “(l)(1) (*Example 1*)” in its place.
 - iii. Adding a sentence to the end of paragraph (k).
3. In paragraph (l), designating Examples 1 through 5 as paragraphs (l)(1) through (5), respectively.
4. In newly designated paragraph (l)(1)(ii), adding a heading to the table.
5. In newly designated paragraph (l)(1)(iii):
 - i. Designating the undesignated paragraph before the first table as paragraph (l)(1)(iii)(A) and adding a heading for the table in newly designated paragraph (l)(1)(iii)(A).
 - ii. Designating the undesignated paragraph before the second table as paragraph (l)(1)(iii)(B) and adding a heading for the table in newly designated paragraph (l)(1)(iii)(B).
 - iii. Designating the undesignated paragraph before the third table as paragraph (l)(1)(iii)(C) and adding a heading for the table in newly designated paragraph (l)(1)(iii)(C).
6. Adding headings for the tables in newly designated paragraphs (l)(1)(v), (vi), and (vii).
7. In newly designated paragraph (l)(3)(i), removing the language “Example 2” and adding “Example 2 in paragraph (l)(2) of this section” in its place.
8. Adding paragraph (l)(6).

The revision and additions read as follows:

§1.641(c)-1 Electing small business trust.

* * * * *

(b) * * *

(1) Grantor portion--(i) In general. Subject to paragraph (b)(1)(ii) of this section, the grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E of the Code.

(ii) Nonresident alien deemed owner. If, pursuant to section 672(f)(2)(A)(ii), the deemed owner of a grantor portion of the ESBT is a nonresident alien, as defined in section 7701(b)(1)(B) (NRA), the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion, as defined in paragraph (b)(2) of this section, of the ESBT.

(2) S portion--(i) In general. Subject to paragraph (b)(2)(ii) of this section, the S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E of the Code.

(ii) Nonresident alien (NRA) deemed owner of grantor portion. The S portion of an ESBT also includes the grantor portion of the items of income, deduction, and credit reallocated under paragraph (b)(1)(ii) of this section from the grantor portion of the ESBT to the S portion of the ESBT.

* * * * *

(k) Applicability date. * * * Paragraphs (b)(1) and (2) of this section, and Example 6 in paragraph (l)(6) of this section, apply to all ESBTs after December 31, 2017.

(I) * * *

(1) * * *

(ii) * * *

Table 1 to paragraph (I)(1)(ii)

* * * * *

(iii) * * *

(A) * * *

Table 2 to paragraph (I)(1)(iii)(A)

* * * * *

(B) * * *

Table 3 to paragraph (I)(1)(iii)(B)

* * * * *

(C) * * *

Table 4 to paragraph (I)(1)(iii)(C)

* * * * *

(v) * * *

Table 5 to paragraph (I)(1)(v)

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(vi) * * *

Table 6 to paragraph (I)(1)(vi)

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(vii) * * *

Table 7 to paragraph (I)(1)(vii)

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(6) Example 6: NRA as potential current beneficiary. Domestic Trust (DT) has a valid ESBT election in effect. DT owns S corporation stock. The S corporation owns U.S. and foreign assets. The foreign assets produce foreign source income. B, an NRA, is the grantor and the only trust beneficiary and potential current beneficiary of DT. B is not a resident of a country with which the United States has an income tax treaty. Under section 677(a), B is treated as the owner of DT because, under the trust documents, income and corpus may be distributed only to B during B's lifetime. Paragraph (b)(2)(ii) of this section requires that the S corporation income of the ESBT that otherwise would have been allocated to B under the grantor trust rules must be reallocated from B's grantor portion to the S portion of DT. In the example in this paragraph (l)(6), the S portion of DT is treated as including the grantor portion of the ESBT, and thus all of DT's income from the S corporation is taxable to DT.

Par. 3. Section 1.1361-1 is amended by:

1. Revising paragraph (m)(1)(ii)(D).
2. Revising paragraph (m)(2)(ii)(E)(2).
3. Adding two sentences to the end of paragraph (m)(4)(i).
4. Revising the second sentence of paragraph (m)(5)(iii).
5. In paragraph (m)(8), designating Examples 1 through 9 as paragraphs (m)(8)(i) through (ix), respectively.
6. Redesignating paragraphs (m)(8)(i)(i) through (iii) as paragraphs (m)(8)(i)(A) through (C), respectively.
7. Redesignating paragraphs (m)(8)(ii)(i) and (ii) as paragraphs (m)(8)(ii)(A) and (B), respectively, and revising the second sentence of newly redesignated paragraph (m)(8)(ii)(A).
8. In the first sentence of newly redesignated paragraph (m)(8)(ii)(B), removing the language "Example 2(i)" and adding "Example 2 in paragraph (m)(8)(ii)(A) of this section" in its place.

9. Redesignating paragraphs (m)(8)(vi)(i) through (iii) as paragraphs (m)(8)(vi)(A) through (C), respectively, and revising the first sentence of newly redesignated paragraph (m)(8)(vi)(B).

10. In the first sentence of newly redesignated paragraph (m)(8)(vi)(C), removing the language “paragraph (i) of this Example 6” and adding “Example 6 in paragraph (m)(8)(vi)(A) of this section” in its place.

11. In paragraph (m)(9):

i. Removing the language “Paragraphs (m)(2)(ii)(A), (m)(4)(iii) and (vi), and (m)(8), Example 2, Example 5, Example 7, Example 8, and Example 9” from the second sentence and adding “Paragraphs (m)(2)(ii)(A) and (m)(4)(iii) and (vi) of this section and Examples 2, 5, and 7 through 9 in paragraphs (m)(8)(ii), (v), and (vii) through (ix), respectively,” in its place.

ii. Adding a sentence at the end of the paragraph.

The revisions and additions read as follows:

§1.1361-1 S corporation defined.

* * * * *

(m) * * *

(1) * * *

(ii) * * *

(D) Nonresident aliens. A nonresident alien (NRA), as defined in section 7701(b)(1)(B), is an eligible beneficiary of an ESBT and an eligible potential current beneficiary.

* * * * *

(2) * * *

(ii) * * *

(E) * * *

(2) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1); for the purpose of this paragraph (m)(2)(ii)(E)(2), an NRA potential current beneficiary does not violate the requirement under section 1361(b)(1)(C) that an S corporation cannot have an NRA as a shareholder.

* * * * *

(4) * * *

(i) * * * An NRA potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100-shareholder limit under section 1361(b)(1)(A). However, an NRA potential current beneficiary of an ESBT is not treated as a shareholder in determining whether a corporation is a small business corporation for purposes of the NRA-shareholder prohibition under section 1361(b)(1)(C).

* * * * *

(5) * * *

(iii) * * * For example, the S corporation election will terminate if a charitable remainder trust becomes a potential current beneficiary of an ESBT. * * *

* * * * *

(8) * * *

(ii) * * *

(A) * * * On January 1, 2006, A, a partnership, becomes a potential current beneficiary of Trust. * * *

* * * * *

(vi) * * *

(B) * * * Assume the same facts as Example 6 in paragraph (m)(8)(vi)(A) of this section except that D is a charitable remainder trust. * * *

* * * * *

(9) * * * Paragraphs (m)(1)(ii)(D), (m)(2)(ii)(E)(2), (m)(4)(i), (m)(5)(iii), and (m)(8) of this section apply to all ESBTs after December 31, 2017.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

Approved: June 10, 2019

David J Kautter,

Assistant Secretary of the Treasury (Tax Policy).

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